STATE OF CALIFORNIA

880.0641

STATE BOARD OF EQUALIZATION
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March 1, 1999

Mr.

Dear Mr. :

This is in response to your letter of February 1, 1999 to Larry Augusta requesting an opinion regarding application of the welfare exemption to two hypothetical procurement entities wholly-owned by a qualifying medical center. You posit two restructuring scenarios involving the creation of a wholly-owned and controlled procurement entity which would act as a purchasing agent for a tax exempt IRC Section 501(c)(3) medical center (which we interpret to mean a qualifying "hospital" for purposes of Revenue and Taxation Code section 214) and lease and sell machinery and equipment to the center. One scenario would have the procurement entity be an IRC Section 501(c)(3) corporation and the other would have a Limited Liability Company (LLC) procurement entity with the medical center as the single LLC member. You have asked for our opinion on the following questions: (1) if either or both procurement entities would be eligible entities for purposes of the welfare exemption, and (2) if leasing the machinery and equipment by the two alternative entities to the medical center would jeopardize the application of the welfare exemption to the same machinery and equipment.

From the facts you have described, we have concluded that the welfare exemption would be available for the IRC Section 501(c)(3) procurement entity and the machinery and equipment owned by it and sold or leased to the medical center.. The LLC, however, would not be a qualifying entity under Section 214, nor would its separate status be disregarded to allow it to qualify under the status of the medical center. Thus the machinery and equipment purchased by the LLC would not be eligible for the welfare exemption, unless purchased by the LLC as an agent for the medical center or unless sold on a regular or conditional sales basis to the medical center, at which time the property would be eligible for the exemption as hospital property. Because we do not have enough information on which to analyze the agency issue or the nature of the "lease" to the medical center, we will focus our attention on the eligibility of the entities and the effect of the Treasury Regulations. However, as is the case for all welfare exemption claims, until a claim and all required supportive documentation is filed and reviewed, specific findings of eligibility or ineligibility as to specific property or properties cannot be made.

Scenario No. 1 – Procurement Entity as IRC Section 501(c)(3) Corporation

Facts As Set Forth in Your Letter

You state:

> The Medical Center, which is an IRC Section 501(c)(3) entity, will create a wholly owned and controlled subsidiary named Corporation A. Corporation A will act as the purchasing agent and will procure machinery and equipment (M&E) and other supplies exclusively for and under the sole direction of the Medical Center. Corporation A will sell or lease the procured M&E and other supplies to the Medical Center. The procurement functions are currently being performed by the purchasing department of the Medical Center which will become Corporation A under this scenario. Corporation A is being established to achieve economies of scale, enhance relationships with suppliers, obtain more favorable vendor discounts, and decrease the cost of the purchasing function.
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> Pursuant to CRTC Section 214 and all of its subsections, Corporation A and its leases of M&E to the Medical Center will be structured in accordance with the requirements specified therein, as follows:
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> - Corporation A will be an exempt organization under IRC Section 501(c)(3) of the Internal Revenue Code; and
> - The M&E and other supplies that Corporation A purchases for and sells or leases to the Medical Center will be "irrevocably dedicated" to exempt hospital purposes and will be ultimately owned, controlled and operated by the Medical Center; and
> - Upon liquidation, dissolution or abandonment by Corporation A, ownership of any leased assets or equipment will revert back to the Medical Center; and
> - No part of the new earnings of Corporation A will inure to the benefit of any private shareholder or individual.

Analysis

Revenue and Taxation Code Section 214.11 states that for purposes of Section 214, property owned and operated by a nonprofit organization, otherwise qualifying for exemption under Section 214, shall be deemed to be exclusively used for hospital purposes so long as the property is exclusively used to meet the needs of hospitals which qualify for exemption from property tax under Section 214 or any other law of the United States or this state. As used in that section, "needs of hospitals" includes any use incidental to, and reasonably necessary for, the functioning of a full hospital operation. Thus, a nonprofit corporation formed by a hospital that qualifies for the welfare exemption to acquire property for it for hospital use could be eligible for the exemption under this section, assuming that it and its property meet all of the requirements of section 214 and following. (Particular organizational and use requirements are set forth in sections 214(a), 214.01, and 214.8.)

Scenario No. 2 – Procurement Entity as Single Member Limited Liability Company (LLC)

Facts As Set Forth in Your Letter

You state:

> The Medical Center, which is an IRC Section 501(c)(3) entity, will create a single member LLC which will operate as a division of the Medical Center. The Medical Center will be the single member owner of the LLC, which will be created solely for the use of and operated under the absolute and direct control of the Medical Center. The single member LLC will act as a procurement company for the Medical Center and will sell supplies and lease M&E it purchases solely tot he Medical Center. The single member LLC will maintain separate books and records as a division of the Medical Center, but will not file separate federal or California income tax returns or filings because the single member LLC will not file an affirmative election to be classified as a corporation under IRS Treasury Regulation Section 301.7701(a).
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> Accordingly, the single member LLC will be treated as a disregarded entity for state and federal income tax purposes by the California Franchise Tax Board and the IRS. Under proposed Treasury Regulation Section 301.7701.3 a single owner entity that is disregarded for state and federal income tax purposes must use its owner's taxpayer identification number (TIN) which is an indicator that this entity should be treated as a division rather than a separate legal entity. In addition, the instructions for Federal Form 8832, Entity Classification Election, state that an entity should include its owner's Employers Identification Number when treated as a disregarded entity.

Analysis

If the machinery and equipment is owned by a procurement entity created by the Medical Center as a single member LLC, wholly-owned and controlled by the Medical Center, the property will not be able to qualify for exemption from tax under section 214.11 because it will not be owned by "a nonprofit organization otherwise qualifying for exemption under section 214." Under California law, a limited liability company (LLC) is a separate entity from its member(s) and there is currently no statutory authorization for disregarding that separate entity for property tax purposes. An LLC is not a nonprofit entity, therefore if the LLC leased the machinery and equipment to the Medical Center, the property would not be eligible for the welfare exemption because the property would not be owned and used by qualifying organizations, as Section 214 requires. If the LLC purchased the property as an agent for the Medical Center, however, or it purchased and sold the property to the Medical Center, the property could be eligible for the exemption when owned by the Medical Center as hospital property.

Under California law, an LLC must have at least two members. (Corp. Code Section 17050.) Although California allows single member LLC's formed in other states to qualify to do business in California, they are considered separate legal entities for all purposes. Pursuant to IRS "check the box" regulations and 1997 conforming state legislation, single member LLC's are permitted to elect to be considered as a separate corporation or as a division of their single corporate member for state and federal **income tax filing purposes** only. The IRS has allowed single member LLC's owned by 501(c)(3) exempt entities to take advantage of its "check the box" regulations for purposes of income tax filing, but the LLC's are not "recognized" as exempt or issued tax exemption letters in their own name. Although IRS attorneys believe that donations received by a single member LLC owned by a 501(c)(3) organization would probably be recognized as charitable donations, the issue has not been formally addressed by the agency nor regulations proposed to clarify the issue. (Conversation with Judy Kindell, Tax Law Specialist, Projects Unit of IRS Exempt Organization Division.) At any rate, a single member LLC would not be able to present "a valid unrevoked letter or ruling from either the Franchise Tax Board or, in the alternative, the Internal Revenue Service, which states that the organization qualifies as an exempt organization under the appropriate provisions of the Bank and Corporation Tax Law or the Internal Revenue Code." (Rev. & Tax. Code section 214.8(b).)

Although the California Legislature did conform franchise tax filing requirements for single member LLC's to federal law in 1997, it has not seen fit to make a similar provision for property tax. Under California law a foreign single member LLC would be viewed as an entity separate from its single member for purposes pertinent to property tax, namely ownership and operation or use of property. Therefore, unless the single member's exemption letter were deemed to qualify the LLC under Revenue and Taxation Code section 214.8, property owned by the LLC could not be eligible for the exemption. Given the fact that LLC's are essentially business entities and that the Legislature has not allowed the formation of single member LLC's in California, we do not believe that current statutory law could be construed to allow the Board and assessors to disregard the separate existence of a single member LLC and allow the single member's exemption to encompass property owned by the LLC.

In summary, then, while specific statutory and regulatory provisions may allow a single member LLC to disregard its separate existence for purposes of income tax filing, there is no authority for disregarding its separate status for purposes of ownership and operation or use of property and eligibility for the welfare exemption under Section 214. Accordingly, machinery and equipment purchased and owned by a single member LLC and leased to a qualifying Medical Center will not be eligible for the welfare exemption; whereas machinery and equipment purchased and owned by a qualifying 501(c)(3) purchasing entity and leased to the medical center for use consistent with the "needs of hospital" provision of Section 214.11 could be eligible for the welfare exemption.

Again, as the welfare exemption requires the annual filing of a claim for exemption, and as granting or denying of a claim is dependent upon actual circumstances as they exist, our response at this time is informational only and not determinative.

Sincerely,

Susan Scott
Tax Counsel

SS:jd
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cc: Honorable John Chiang, Member
Mr. Timothy W. Boyer, Chief Counsel
Mr. Dick Johnson, Deputy Director, Property Tax
Mr. David Gau, Chief, Policy Planning & Standards
Ms. Jennifer Willis, Taxpayer Rights Advocate
Mr. Pete Gaffney